

1
2
3
4
5
6
7
8 **UNITED STATES DISTRICT COURT**
9 **SOUTHERN DISTRICT OF CALIFORNIA**

10 IN RE MAXWELL
11 TECHNOLOGIES, INC.,
12 SECURITIES LITIGATION.

CASE NO. 13-CV-00580-BEN (RBB)

**ORDER GRANTING MOTION TO
DISMISS**

[Docket No. 50]

14 Before this Court is a Motion to Dismiss filed by Defendants Maxwell
15 Technologies, Inc. (Maxwell), David J. Schramm, and Kevin S. Royal. (Docket No.
16 50). For the reasons stated below, the Motion is **GRANTED**.

17 **BACKGROUND**

18 Maxwell Technologies is a Delaware corporation based in San Diego, CA.
19 Maxwell develops, manufactures, and markets energy storage and power delivery
20 products, with a primary focus on ultracapacitors. Schramm served as CEO and
21 President of Maxwell from July 2007 to December 31, 2013, and reached an agreement
22 to serve as an advisor for two additional years. Royal has been the Senior Vice
23 President, CFO, Treasurer, and Secretary of Maxwell since April 2001.

24 On March 7, 2013, Maxwell announced that it was restating its financial
25 statements for 2011 and the first three quarters of 2012. Maxwell's sales organization
26 made secret arrangements with certain distributors for special payment terms. The
27 distributors would not have to pay Maxwell until the distributor was paid by the
28 customers. Under Maxwell's revenue recognition policy, revenue is only to be

1 recognized where certain conditions are met, including that the collectability of the
2 revenue is “reasonably assured.” (Compl. ¶¶ 29, 134-35). However, Maxwell
3 recognized the revenue from these sales too early, causing the financial statements to
4 overstate revenue. The inaccurate revenue numbers had been included in a number of
5 SEC filings signed by Schramm and Royal. These filings assert that GAAP principles
6 are used and that the financial statements “present fairly the financial position, results
7 of operations, and cash flows” of Maxwell. (*Id.* ¶ 118). Schramm and Royal also
8 spoke on a number of conference calls about Maxwell and its financial performance.

9 On April 26, 2012, Maxwell announced disappointing financial results for the
10 first quarter of 2012. (*Id.* ¶¶ 10, 85). A one-day drop of \$6.20 per share, from \$15.80
11 per share to \$9.60 per share, followed. (¶¶ 10, 86, 162). On March 7, 2013, Maxwell
12 announced that there had been errors in past restatements, that it was required to restate
13 results for 2011 and the first three quarters of 2012. (*Id.* ¶ 11). It also stated that it had
14 to delay its annual report, that there were problems with internal controls and its credit
15 agreement, and announced terminations and resignations of some Maxwell executives.
16 (*Id.*) The next day, shares fell \$1.01. (*Id.*) On March 19, 2013, Maxwell announced
17 that McGladrey LLP had resigned as the independent accounting firm because it could
18 not rely on management’s representations and continuing internal control deficiencies.
19 (*Id.* ¶¶ 4, 13, 90). The stock price fell the next day. (*Id.* ¶ 91¹). Plaintiff contends that,
20 overall, the stock price dropped more than 70% from the class period high of \$21.20
21 per share. (*Id.*) On April 30, 2013, Maxwell disclosed that the DOJ and SEC had
22 begun investigations.

23 Maxwell published the restated financial statements on August 1, 2013. In total,
24 Maxwell states that \$10.1 million in revenue had been recognized prematurely in 2011,
25 and \$9.2 million had been recognized prematurely in 2012. (*Id.* ¶ 154). Maxwell
26 asserts that there were no phony transactions and that, with insignificant exceptions,
27

28 ¹The Court notes that the Complaint is inconsistent with respect to the exact size
of the drop in the stock price on March 20, 2013. (Compl. ¶¶ 13, 91).

1 Maxwell has been paid for all of the problematic sales transactions subject to the
2 restatement. (Mot. at 5; Def. Ex. A at 11²).

3 Maxwell's audit committee conducted an investigation using outside counsel and
4 forensic accountants. Certain Maxwell employees were terminated, and Senior Vice-
5 President of Sales and Marketing Van Andrews resigned. While the investigation was
6 ongoing, Maxwell's accountants, McGladrey LLP, resigned. McGladrey stated that
7 they had decided not to accept representations from the current management and that
8 Maxwell lacked sufficient internal controls over revenue recognition. Maxwell hired
9 new accountants, who accepted representations from current management, including
10 both individual defendants. Investigations have been commenced by the Securities and
11 Exchange Commission (SEC) and the Department of Justice (DOJ).

12 In the wake of the restatements, several lawsuits were filed against Maxwell and
13 the individual defendants on behalf of persons or entities that purchased Maxwell
14 stock. On October 24, 2013, this Court consolidated four actions, and appointed The
15 Employees' Pension Plan of the City of Clearwater as Lead Plaintiff ("Plaintiff").
16 (Docket No. 44). Plaintiff filed a Consolidated Complaint (Compl.) on January 17,
17 2014. (Docket No. 49). The Complaint, filed on behalf of persons or entities who
18 purchased Maxwell stock between April 29, 2011 and March 19, 2013 (the "Class
19 Period"), asserts two causes of action: (1) violation of Section 10(b) of the Securities
20 and Exchange Act of 1934 (Exchange Act), and (2) violation of Section 20(a) of the
21 Exchange Act. Plaintiff claims that Defendants made false statements about Maxwell's
22 financial condition and internal controls, and that Schramm and Royal knew of or
23 participated in the secret side arrangements with distributors.

24
25 ²Defendants ask this Court to take judicial notice of documents referenced in the
26 complaint and filed with the United States Securities and Exchange Commission.
27 (Docket No. 50-2). Plaintiff did not state any objection to this Court taking judicial
28 notice of these documents. Documents incorporated by reference in the Complaint and
whose authenticity no party questions, are properly considered in a Rule 12(b)(6)
motion. *E.g., DeMarco v. DepoTech Corp.*, 149 F. Supp. 2d 1212, 1218 (S.D. Cal.
2001) (taking judicial notice of SEC filings referred to in the complaint). Accordingly
the Request for Judicial Notice is **GRANTED**.

On February 20, 2014, Defendants filed a Motion to Dismiss the Complaint on the grounds that Plaintiff failed to sufficiently allege scienter and that loss causation fails as to the April 26, 2012 announcement. (Docket No. 50).

LEGAL STANDARDS

Section 10(b) of the Exchange Act makes it unlawful to:

use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b). Pursuant to that section, the SEC promulgated Rule 10b-5, which makes it unlawful, in relevant part, to “make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstance under which they were made, not misleading.” 17 C.F.R. § 240.10b-5(b). Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a), states that a person who:

directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such a controlled person is liable . . . unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Section 20(a) claims may be dismissed summarily if the plaintiff fails to adequately plead a primary violation of section 10(b). *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 990 (9th Cir. 2009) (citations omitted).

To state a securities fraud claim, a plaintiff must plead (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase and sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation. *Matrix Init. Inc. v. Siracusano*, 131 S.Ct. 1309, 1317 (2011); *Reese v. Malone*, No. 12-35260, 2014 WL 555911, at *5 (9th Cir. Feb. 13, 2014) (citations omitted). Scienter is “a mental state embracing intent to deceive, manipulate, or defraud.” *Ernst & Ernst*

1 v. *Hochfelder*, 425 U.S. 185, 193 n.12 (1976).

2 In ruling on a motion to dismiss in a securities fraud class action, the court
3 assumes all factual allegations to be true. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*,
4 551 U.S. 308, 322 (2007). A court considers the complaint in its entirety, as well as
5 other sources courts ordinary examine when ruling on Rule 12(b)(6) motions to
6 dismiss, such as documents incorporated into the complaint by reference and matters
7 of which a court may take judicial notice. *Id.*

8 At the pleading stage, a complaint stating claims under section 10(b) and Rule
9 10b-5 must satisfy the dual pleading requirements of Federal Rule of Civil Procedure
10 9(b) and the Private Securities Litigation Reform Act of 1995 (PSLRA). Rule 9(b)
11 requires a party to “state with particularity” the circumstances constituting fraud or
12 mistake, but allows conditions of a person’s mind to be alleged generally. However,
13 the PSLRA applies special requirements to private actions for securities fraud. Where
14 a plaintiff may only recover money damages on proof that a defendant acted with a
15 particular state of mind, the complaint must, as to each alleged act or omission, “state
16 with particularity facts giving rise to a strong inference that the defendant acted with
17 the required state of mind.” 15 U.S.C. § 78u-4(b)(2)(A).

18 The Ninth Circuit has held that in a securities fraud action, plaintiffs must show
19 that defendants engaged in “knowing” or “intentional conduct.” *South Ferry LP, No.*
20 *2 v. Killinger*, 542 F.3d 776, 782 (9th Cir. 2008) (citing *In re Silicon Graphics, Inc.*
21 *Sec. Litig.*, 183 F.3d 970, 975 (9th Cir. 1999)). Reckless conduct can meet the standard
22 to the extent it “reflects some degree of intentional or conscious misconduct,” or what
23 has been termed “deliberate recklessness.” *Id.* (citing *Silicon Graphics*, 183 F.3d at
24 977). In pleading deliberate recklessness, the plaintiff must plead a “highly
25 unreasonable omission, involving not merely simple, or even inexcusable negligence,
26 but an extreme departure from the standards of ordinary care, and which presents a
27 danger of misleading buyers or sellers that is either known to the defendant or is so
28 obvious that the actor must have been aware of it.” *Zucco*, 552 F.3d at 991 (quoting

1 *Silicon Graphics*, 183 F.3d at 976). Facts showing “mere recklessness,” or motive and
2 opportunity to commit fraud, provide some reasonable inference of intent, but are not
3 independently sufficient. *Reese v. Malone*, 2014 WL 555911, at *7 (citing *Silicon*
4 *Graphics*, 183 F.3d at 974).

5 The strong inference is required to be “cogent and compelling, thus strong in
6 light of other explanations.” *Tellabs*, 551 U.S. at 324. The inquiry is “inherently
7 comparative” and requires that a court consider plausible, nonculpable explanations for
8 the defendant’s conduct, as well as inferences favoring the plaintiff. *Id.* Although the
9 inference that a defendant acted with scienter need not be irrefutable or the “most
10 plausible” of competing inferences, it must be more than merely “reasonable” or
11 “permissible.” *Id.* A complaint will survive “only if a reasonable person would deem
12 the inference of scienter cogent and at least as compelling as any opposing inference
13 one could draw from the facts alleged.” *Id.* The relevant inquiry is “whether *all* of the
14 facts alleged, taken collectively, give rise to a strong inference of scienter, not whether
15 any individual allegation, scrutinized in isolation, meets that standard.” *Id.* at 323
16 (emphasis in original). In reviewing the sufficiency of scienter allegations after
17 *Tellabs*, the Ninth Circuit has conducted a dual inquiry in which it first determines if
18 any allegation, standing alone is sufficient to create a strong inference of scienter.
19 *Zucco*, 552 F.3d at 992. If not, it examines the complaint holistically to determine if
20 the insufficient allegations combine to create a strong inference of intentional conduct
21 or deliberate recklessness. *Id.*

22 DISCUSSION

23 Defendants argue that Plaintiff has failed to sufficiently allege scienter. They
24 argue that the Complaint does not allege facts giving rise to the “strong inference” that
25 Schramm or Royal were involved in or knew of the secret side arrangements which
26 caused the restatement. (Mot. at 2).

27 Plaintiff points to a number of different allegations which it contends are
28 sufficient to raise a strong inference of scienter, when viewed holistically. Plaintiff

1 points to the statements of five confidential witnesses included in the complaint. It also
2 points to a variety of other facts, such as the “noisy” resignation of Maxwell’s auditor,
3 the individual defendants’ performance-based compensation, government
4 investigations, the individual defendant’s role in the corporate structure, and alleged
5 involvement in relevant transactions. Defendants dispute that such allegations give rise
6 to a strong inference, and point to other facts which they contend undermine a strong
7 inference of scienter.

8 This Court individually examined the various allegations raised to determine if
9 they are sufficient to create a strong inference of scienter. As none are individually
10 sufficient, the Court examined them holistically to determine if they create a strong
11 inference of scienter when viewed in combination. As this Court determines that a
12 strong inference of scienter is not created, it will not proceed to unnecessarily consider
13 loss causation.

14 A. Corporate Scienter

15 Plaintiff argues that corporate scienter is satisfied because defendants Schramm
16 and Royal, as well as non-defendant Andrews, were senior-level executives responsible
17 for Maxwell’s core operations and acted with the requisite scienter. (Opp’n at 10).
18 Plaintiff argues that Maxwell’s corporate scienter is “beyond reasonable dispute”
19 because it admitted that Andrews left the company “as a result” of the investigation
20 into wrongdoing. (Opp’n at 4). Plaintiff contends that the scienter of Andrews,
21 Schramm, and Royal can be imputed to Maxwell, and that Maxwell is liable for the
22 securities fraud of its “controlling employees.” (*Id.*)

23 Defendants do not appear to dispute that the scienter of named individual
24 defendants Schramm or Royal can be imputed to Maxwell, but argues that non-
25 defendant Andrews’ scienter cannot be so imputed. Defendants argue that the effort
26 to attribute the knowledge of an employee to the company is an attempt to use a
27 “collective scienter” theory which is not the law in this Circuit. (Reply at 1).
28 Defendants cite to *Glazer Capital Mgmt., LP v. Magistri*, 549 F.3d 736, 744-45 (9th

1 Cir. 2008), in which the Ninth Circuit noted a circuit split on the issue, and stated that
2 its precedent did not foreclose the possibility that collective scienter might be
3 appropriate in some circumstances. However, the Ninth Circuit in *Glazer* required that
4 a plaintiff who rested his claim on three statements in a legal document plead scienter
5 as to the individuals who actually made the false statements in the merger agreement.
6 *Id.* at 745. The Ninth Circuit did not lay out a test for determining when individual
7 scienter might not be required, but stated that it reached its conclusion based on the
8 “nature and unique context of the alleged misstatements in this case.” *Id.*

9 This Court has examined the arguments raised by Plaintiff, and has determined
10 that Plaintiff has not demonstrated that collective scienter is applicable here. As in
11 *Glazer*, this Court looks at the nature and context of the misstatements. Plaintiff’s
12 claims are based upon statements by the individual defendants and in official filings
13 signed by the individual defendants. It is thus necessary to require scienter as to the
14 individuals who were responsible for the statements. This is not a situation in which
15 the fact that Andrews or another employee may have had the requisite knowledge
16 indicated that the individual defendants who made or authorized statements knew they
17 were false when they were made. The fact that Andrews, a non-defendant, allegedly
18 had knowledge of misconduct does not indicate that any statements were made with the
19 necessary mental state.

20 The Court has examined the cases cited by Plaintiff. Although the case law
21 supports holding a corporation responsible for the actions of its executives, Plaintiff
22 does not cite cases that support corporate scienter based only upon the scienter of a
23 non-defendant who did not make or certify the statements at issue. Thus, although this
24 Court agrees with Plaintiff that corporate scienter is alleged if it is sufficiently alleged
25 that Schramm or Royal had the necessary mental state, corporate scienter is not
26 sufficiently alleged under these circumstances where one executive had the knowledge
27 and other, perhaps-innocent executives made the statements.

28 ///

1 B. Plaintiff's Arguments for Individual Scienter

2 Plaintiff's briefing points to numerous allegations which it contends support a
3 strong inference that Schramm and Royal had the necessary mental state.

4 i. Confidential Witnesses

5 The principal argument set forth by Plaintiff is that a strong inference of scienter
6 arises from the statements made by five confidential witnesses who are described and
7 quoted in the Complaint. Plaintiff contends that these statements support the claim that
8 Schramm and Royal engaged in, or knew about, the side deals and improperly realized
9 revenue. Defendants raise numerous challenges to the statements.

10 A complaint relying upon statements from confidential witnesses must pass two
11 hurdles to satisfy the PSLRA pleading requirements. *Zucco*, 552 F.3d at 995. First,
12 the confidential witnesses must be "described with sufficient particularity to establish
13 their reliability and personal knowledge." *Id.* (citing *In re Daou Systems, Inc.*, 411
14 F.3d 1006, 1015-16 (9th Cir. 2005)). Second, the statements themselves must be
15 "indicative of scienter." *Id.* (citing *Daou*, 411 F.3d at 1022).

16 a. Confidential Witness #1

17 Confidential Witness #1 (CW1) was Maxwell's Vice President of Business
18 Development from January 2006 to March 2013. (Compl. ¶ 52 n. 16). CW1 initially
19 reported to Schramm, and after 2010 reported to Andrews and Schramm. (*Id.*) CW1
20 was fired for purported involvement in the accounting scheme. (*Id.*) CW1 reports that
21 "things definitely changed" after Andrews arrived and that she³ was taken "out of the
22 loop" on many of the issues in the restatement. (*Id.* ¶ 52).

23 CW1 reports that she was involved in a shipment of product that was not going
24 to be accepted by the end user. (*Id.* ¶ 61). She reports that Andrews directed her to
25 speak with Alfatec, the company's German distributor, and have the shipment delivered
26 to Alfatec. (*Id.*) CW1 stated that Alfatec knew Maxwell wanted Alfatec to take and
27

28 ³This Court follows Plaintiff's convention of referring to all confidential witnesses with female pronouns to protect confidentiality.

1 store the product, but that Alfatec would not pay for the product at the time. (*Id.*) CW1
2 stated that this arrangement might not be a problem if it had been properly accounted
3 for by Maxwell. (*Id.* ¶ 62). The Complaint says that CW1 reported questioning
4 Andrews about changing the terms of the shipment, and Andrews told her that it was
5 “OK’d by David,” presumably referring to Schramm. (*Id.*) CW1 also states that
6 Andrews was warned by Schramm that he would be fired and allowed to resign, but
7 does not state how she knew Andrews was warned. (*Id.* ¶ 81).

8 Defendants raise a number of arguments regarding CW1. First, they point out
9 that CW1 and CW4 are both former, disgruntled employees. Plaintiff argues that this
10 goes to the witnesses credibility, and it is not appropriate for this Court to determine
11 credibility issues at this stage. This Court agrees with Plaintiff. The Court will
12 examine the witnesses for indicia of reliability and personal knowledge, but it will not
13 ignore detailed and otherwise reliable allegations simply because the witness might
14 have a motive to lie. *See In re Gilead Scis. Sec. Litig.*, No. C 03-4999, 2009 WL
15 3320492, at *2 (N.D. Cal. Oct. 13, 2009).

16 Second, Defendants argue that the confidential witnesses offer sweeping
17 generalizations, not specific facts. Plaintiff’s description of the confidential witness
18 accounts raises serious problems. In reviewing the Complaint’s characterization of
19 their statements, it is often unclear what the witness actually said, what the Plaintiff has
20 inferred, and what is commentary by the Plaintiff. To the extent that certain ideas were
21 expressed by the witness, their basis is often unclear. In particular, this Court cannot
22 determine from the Complaint whether *any* of the confidential witnesses had any
23 reason to believe the individual defendants knew there were improprieties.

24 In the case of CW1, for instance, the Complaint reports that CW1 stated that the
25 arrangements might not have been problematic if reported, then states that “However,
26 the Individual Defendants made sure this was not the case in order to boost Maxwell’s
27 sales figures.” (Compl. ¶ 62) The Complaint does not indicate whether CW1 said this
28 or it is Plaintiff’s commentary. If CW1 did say this, it does not explain the basis for the

1 statement. For instance, the Complaint does not report any statements made by the
2 individual defendants that suggest that they knew the sales were not properly reported
3 to accounting, much less why they did so. The Complaint also states that CW1
4 confirmed that the secret change was ordered by Andrews and Schramm, and the
5 Opposition indicates that CW1 stated that Schramm ordered secret alteration of terms
6 and Andrews carried them out. (*Id.*; Opp'n at 16). However, the Complaint does not
7 indicate what, if anything, CW1 said to indicate that she concluded that Andrews or
8 Schramm knew it was secret, on what basis she reached that conclusion, or whether
9 either man actually ordered her to do it without telling anyone. This Court therefore
10 cannot tell whether this statement is CW1's characterization of events or merely
11 Plaintiff's interpretation of the fact that CW1 was told to change the payment terms.
12 There is also no basis from which this Court could conclude that CW1 had personal
13 knowledge of the fact that Andrews was warned in advance of the terminations.

14 It appears that CW1 was in a position to know about the existence of unreported
15 side arrangements, and might have plausibly learned whether the individual defendants
16 were aware of the sales arrangements and how they were reported to accounting.
17 However, in order for the statement of CW1 to support scienter, Plaintiff must give this
18 Court a sufficiently clear indication of what CW1 actually said and the basis for that
19 statement. With respect to much of the description of CW1's statement, this Court
20 cannot determine which allegations and comments were made by CW1. To the extent
21 it is clear Plaintiff is relating the statement of CW1, Plaintiff has frequently failed to
22 establish reliability and personal knowledge. Those statements for which reliability
23 and personal knowledge have been established are not sufficiently indicative of
24 scienter. Although Plaintiff's characterization suggests that CW1 may possess
25 evidence of scienter, Plaintiff has not communicated that evidence in a way that allows
26 this Court to infer scienter.

27 ///

28 ///

1 b. Confidential Witness #2

2 Confidential Witness #2 (CW2) was Maxwell's Sales Operations Manager from
3 February 2008 to May 2011. (Compl. ¶ 53 n. 17). CW2 was responsible for sales
4 reporting and client contracts, including the preparation of sales reports and attendance
5 at weekly sales meetings. (*Id.*) These reports included information about outstanding
6 sales, received orders, unfulfilled sales, and invoiced orders. (*Id.*) The Complaint
7 alleges that CW2 characterized the environment at Maxwell as becoming more
8 secretive and restrictive after Andrews arrived. (*Id.* ¶ 53). CW2 is reported as stating
9 that she did not trust Andrews and that he was a typical sales person who "pushed to
10 get stuff done" at the end of quarters. (*Id.*) CW2 stated that she was "not surprised"
11 by the need for the restatement. (*Id.*) CW2 reports that Andrews excluded her from
12 weekly sales meetings after he arrived, but that she still sent reports to Andrews. (*Id.*
13 ¶ 63). CW2 is quoted as saying she was "sure at the time" that there were orders being
14 reported as booked when that was not actually the case. (*Id.*) CW2 also stated that
15 Andrews addressed issues or discrepancies with the terms of the transaction. (*Id.*)

16 The account of CW2 does not support a strong inference of scienter. There is
17 no indication in the statement that Schramm or Royal were aware of the side deals, or
18 the fact that the deals were not reported. Indeed, it is not clear that CW2 actually knew
19 anything about the scheme while at Maxwell, much less who was involved.
20 Defendants also correctly point out that CW2 was not working at Maxwell for much
21 of the Class Period. These statements provide little support to infer scienter.

22 c. Confidential Witness #3

23 Confidential Witness #3 (CW3) was Maxwell's Senior Sales Operations
24 Administrator from September 2011 through June 2012. (Compl. ¶ 64 n. 19). CW3
25 was responsible for entering and processing orders, as well as for overseeing the
26 implementation of a customer relationship system. (*Id.*) CW3 participated in weekly
27 Accounts Receivable meetings. (*Id.*) CW3 reported to Andrews and Tara Whiteside,
28 the Business Planning & Sales Operations Manager. (*Id.*) The Complaint reports that

1 CW3 talks about the fact that it was “always a scramble” to process Alfatec orders and
2 put the products “on a boat” to count the orders during the reporting period. (*Id.* ¶ 64)
3 The Complaint states that “CW 3 understood that this was being done so that these
4 orders could be booked as revenue in the quarter about to end even though the
5 Individual Defendants knew this wasn’t the case . . .” (*Id.*) CW3 stated that Schramm,
6 Royal, and Andrews received flash reports that set forth expected sales, which were
7 “always inflated” because of the sales quota. (*Id.* ¶ 65). CW 3 is quoted as saying the
8 “integrity of the orders came into question.” (*Id.*)

9 The Complaint recounts CW3’s description of events involving Maxwell
10 distributor Pana-Pacific. (*Id.* ¶ 66). CW3 reported that she entered terms for the orders
11 based on purchase orders and invoices, but that the terms were not the same as the
12 terms Andrews verbally extended to Pana-Pacific. (*Id.*) CW3 stated that Pana-
13 Pacific’s accounts receivable became past-due and that she raised this issue in the
14 Accounts Receivable meetings, which included Andrews and “on occasion Defendant
15 Royal.” (*Id.* ¶ 67). CW3 says that Whiteside told her that Andrews had a verbal
16 agreement with Pana-Pacific to extend the payment terms. (*Id.*) CW3 stated that
17 extending such terms required Royal’s approval, and the Complaint states that “the
18 CFO should have been involved.” (*Id.*)

19 CW3 also discussed Maxwell’s policy on credit holds. (*Id.* ¶ 68). She stated that
20 additional orders could only be shipped if one of the individual defendants, usually
21 Royal, released the hold. (*Id.*) The hold was released on Pana-Pacific despite unpaid
22 receivables. (*Id.*) CW3 states that Whiteside told her that she should not try to collect
23 from Pana-Pacific because Andrews was “handling it,” and that she should not talk to
24 Andrews about Pana-Pacific. (*Id.* ¶ 69). CW3 states she expressed concerns to
25 Whiteside. (*Id.*) CW3 did state that she felt it was “very weird” to be directed to
26 remain silent about the situation. (*Id.* ¶ 70).

27 CW3’s account cannot support a strong inference of scienter. Although the
28 Complaint’s discussion of CW3 states that the individual defendants knew that revenue

1 was being improperly booked, it is unclear whether CW3 ever says this, or if CW3 has
2 any basis to say this. Although the Complaint indicates that CW3 was told to remain
3 silent, this allegation is too ambiguous to help infer scienter. This Court cannot tell if
4 the Complaint was referencing Whiteside's instructions or one of the individual
5 defendants told her not to talk about the side deals. None of the allegations provide
6 specific facts from which this Court could infer that the individual defendants knew
7 that side deals were not being communicated to the accounting department. At most,
8 it indicates that one or both individual defendants were aware of collection problems
9 and authorized credit hold decisions that allowed additional products to be shipped and
10 improperly booked. It is not, however, clear from the Complaint that Maxwell policy
11 was followed and that either individual defendant actually authorized special terms or
12 lifting credit holds. Plaintiff argues that CW3's testimony "fatally undermines any
13 claim that Royal and Maxwell were unaware of Pana-Pacific's undisclosed extended
14 payment terms." (Opp'n at 15). The Court agrees that it is somewhat undermined.
15 However, even if Schramm and Royal knew about the side deals, this does not indicate
16 that they knew that revenue was improperly booked. Plaintiff also points out that
17 CW3's account of end-of-period activity was corroborated and that other CWs had
18 suspicions about the revenue being booked. (*Id.* at 16). However, Plaintiff has not
19 explained how an active sales department and the suspicions of third parties indicates
20 that the individual defendants knew about the improper accounting.

21 d. Confidential Witness #4

22 Confidential Witness #4 (CW4) was Maxwell's Senior Director of Global Sales
23 and Marketing from August 2012 to March 2013. (Compl. ¶ 71 n.20). CW4 also
24 worked at Maxwell from February 2008 to July 2010 as Director of Sales and
25 Marketing for the Americas. (*Id.*) From 2012, CW4 was responsible for sales strategy
26 and managing customer relationships, and reported to Schramm and Andrews. (*Id.*)
27 CW4 was fired for purportedly having a role in the events leading to the restatement.
28 (*Id.*) CW4 made statements pertaining to both Maxwell business practices, and

1 conversations overheard during carpool rides.

2 First, the Complaint alleges that CW4 states that the illicit business practices
3 were used with clients worldwide. (*Id.* ¶ 71). CW4 provides details on the kinds of
4 arrangements that were made. (*Id.* ¶ 72). CW4 stated that Royal approved extended
5 payment terms, and that only Schramm and Royal could lift a credit hold. (*Id.*)

6 Although these statements allow an inference that the actions of one or both
7 defendants was necessary to carry out the misconduct, it alone does not establish
8 scienter on the part of Schramm or Royal. The fact that the individual defendants made
9 or should have made decisions on payment terms or credit holds does not indicate that
10 they knew that the effects of those decisions were not properly reported to accounting.

11 Second, CW4 makes claims based on the fact that she “often” joined Schramm
12 and Andrews in their carpools. The Complaint states that she heard “off the record
13 conversations” which Plaintiff alleges “included these problematic business practices.”
14 (*Id.* ¶ 82). The Complaint states that CW4 recalled Schramm telling Andrews to “take
15 certain actions necessary to ‘make the numbers,’ and that Schramm boasted that he had
16 ‘a clean bill of health’ regarding his participation in these practices.” (*Id.*) CW4 states
17 that she has a lot of information and can put “a nail in the coffin” of Schramm and
18 Royal. (*Id.*) CW4 claimed that Schramm and Royal were “spearheading” the
19 fraudulent transactions and were responsible for the matters that were restated. (*Id.*
20 ¶ 83). She allegedly claims that they “knew everything” and were “guiding it.” (*Id.*)
21 She states that she was “told what to do” by the individual defendants and that the
22 individual defendants knew what was going on. (*Id.*)

23 The Court has very carefully examined these allegations. These statements
24 certainly indicate that CW4 may have heard or seen something from which this Court
25 could infer scienter. However, as with the other confidential witnesses, it is not always
26 clear what CW4 actually said. Additionally, this Court cannot actually determine what
27 CW4 claims to have heard. Many of the statements about the role of Schramm and
28 Royal are conclusory and without foundation. It is not clear from the pleadings, or

1 from the briefing, whether the carpool conversations acknowledged that revenue was
2 improperly recognized, or if the discussion of problematic business practices meant
3 only that Schramm indicated knowledge of the special sales terms. Although CW4
4 believes CW4 has damaging evidence, Plaintiff has not shared any specific facts from
5 which this Court can conclude that CW4 possesses facts giving rise to scienter.

6 e. Confidential Witness #5

7 Confidential Witness #5 (CW5) was Maxwell's Director of Sales and Marketing
8 from June 2010 to October 2012. (Compl. ¶ 73 n. 21). She was responsible for sales
9 to both customers and distributors. (*Id.*) In her final months, CW5 participated in
10 weekly Days Sales Outstanding meetings with Royal and other executives where they
11 discussed accounts receivables. (*Id.*) She reported to and interacted with Schramm and
12 Royal. (*Id.*)

13 According to the Complaint, CW5 discussed the Alfatec arrangements, including
14 the fact that Alfatec was brought in to serve as a buffer and hold inventory. (*Id.* ¶ 73).
15 CW5 stated that although later deals and purchase orders usually matched the original
16 contract, purchase orders for the transactions in the restatement would not have
17 included the additional terms and concessions. (*Id.* ¶ 74) She stated that the need to
18 restate revenue was "not a surprise" given the clients' failure to send payment. (*Id.*)
19 CW5 also reports that an analyst had asked Schramm why the accounts receivables had
20 grown three-fold, but the sales only grew by a factor of 1.2. (*Id.* ¶ 75). The Complaint
21 characterizes CW5's statement as saying that this analyst was not satisfied with
22 Schramm's answer, that the "analyst published that Schramm's explanations did not
23 make sense" and that the analyst made efforts to get to bottom of the issue. (*Id.*) CW5
24 states that the individual defendants began a weekly meeting in May 2012 regarding
25 past-due accounts, which CW5 attributed to the analyst's inquiry. (*Id.* ¶ 76). Royal
26 directed this meeting, which would discuss accounts where special payment terms had
27 been extended. (*Id.*) From this, the Complaint concludes that the individual
28 defendants "were pushing to present financial results that were in line with the

1 Company's representations to Wall Street." (*Id.*).

2 CW5 also states that while some people at the company blamed lower
3 executives, other people at Maxwell knew that this was not the case. (*Id.* ¶ 79). CW5
4 said the Defendants needed to produce numbers in order to appear to be a growth stock
5 company. (*Id.*). CW5 also stated that Andrews, Royal, and Schramm were close
6 friends and that Schramm and Andrews lived in the same community, went to the same
7 country club, and carpooled every day. (*Id.* ¶ 81).

8 It is unclear from Plaintiff's characterization of CW5's statement whether CW5
9 actually possesses any knowledge from which this Court could conclude there is a
10 strong inference of scienter. The Complaint does indicate that Royal would have been
11 aware of an issue with past-due accounts. However, none of the statements indicate
12 that CW5 heard either individual defendant say anything or knew that the individual
13 defendants heard something that indicates that they knew there was a revenue
14 recognition problem. It is entirely possible from the description that CW5 might have
15 such facts, but Plaintiff must present them clearly; this Court cannot speculate on what
16 CW5 might have meant. The Complaint also fails to indicate if CW5 actually knows
17 what, if anything, the analyst told Schramm. The Complaint's characterization of her
18 statement as saying the analyst "published" that Schramm's explanations did not make
19 sense suggests that CW5 was not present and is relying on hearsay from the unnamed
20 analyst. Although hearsay can be considered, it can indicate that a witnesses' report
21 is "not sufficiently reliable, plausible, or coherent to warrant further consideration
22 under *Daou*." *Zucco*, 552 F.3d at 997 n.4. Here, the fact that CW5 may not have been
23 present undermines this Court's ability to draw significance from her report that an
24 unnamed individual presented unknown facts to Schramm and got a response that did
25 not satisfy him or her. CW5's allegations that the individual defendants and Andrews
26 were friends and shared a social circle do not mean that the individual defendants knew
27 of wrongdoing. It is, however, consistent with the theory that Andrews was working
28 with Royal and Schramm on the scheme and that all three knew about the improperly

1 recognized revenue.

2 f. Conclusion

3 The confidential witness accounts do not indicate that the individual defendants
4 were aware of the recognition problem. The parties are not disputing whether there
5 were accounting improprieties, or the fact that side arrangements were extended. The
6 confidential witness testimony offered by Plaintiff supports an inference that the
7 individual defendants knew that there were some problems with collections, and were
8 aware of special payment terms and credit hold decisions. However, Plaintiff has not
9 indicated that there was anything inherently wrong with extending payment terms or
10 making a special sales arrangement. Such arrangements are a problem *when they are*
11 *not properly taken into account* at the accounting stage. The question is thus whether
12 Schramm and Royal knew that the special sales terms were not being properly taken
13 into account in the financial statements. If the confidential witnesses possess any
14 information on this subject, it was not laid out with sufficient clarity for this Court to
15 infer scienter.

16 To the extent Plaintiff is arguing that the level of the individual defendant's
17 involvement in payment terms and meetings indicates that they must have known there
18 was a problem with the revenue numbers, Plaintiff needs to explain why this is so. The
19 Court cannot speculate.

20 Review of Plaintiff's pleading and the characterizations of the CW statements
21 in Plaintiff's Opposition indicates that Plaintiff may be able to make a stronger case if
22 the Complaint is amended to more clearly and completely explain what the CWs know
23 and have said. To the extent the CWs actually heard or saw something that indicated
24 that the individual defendants knew the terms were secret or that sales were improperly
25 booked, Plaintiff should clearly lay these facts out. Plaintiff should avoid
26 characterizing the testimony in a manner that makes it difficult for this Court to
27 differentiate between witness statements and Plaintiff's own conclusions.

28 ///

1 ii. Andrews

2 Plaintiff alleges that Andrews was the “third in command” who reported directly
3 to Schramm and Royal. (Compl. ¶ 51). Plaintiff claims that the culture of Maxwell
4 changed dramatically, “becoming more secretive and isolationist.” (*Id.*) It also points
5 to the fact that Maxwell’s financial results increased nearly immediately after Andrews
6 was hired. (*Id.* ¶ 54). The confidential witness accounts indicate that Andrews had
7 strong personal relationships with the individual defendants, and was actively involved
8 in extending special sales terms and handling past-due accounts. Such allegations may
9 support claims of misconduct by Andrews, but they do not establish that Royal or
10 Schramm were involved. The personal relationship between Andrews and the
11 individual defendants is consistent with their cooperation in a revenue scheme, but the
12 existence of a warm relationship does not indicate that Schramm and Royal knew what
13 Andrews was doing or that they knew that special sales terms were not properly
14 considered in Maxwell’s accounting.

15 iii. Auditor’s Resignation

16 Plaintiff argues that the “noisy” resignation of Maxwell’s auditor supports a
17 strong inference of scienter. Plaintiff points to the fact that McGladrey LLP resigned
18 in part because it could not rely on representations from current management and
19 certain third parties. (Opp’n at 18). Plaintiff argues that this is consistent with
20 allegations that Defendants colluded with third parties to improperly recognize revenue
21 through undisclosed arrangements. (*Id.*) Plaintiff emphasizes that Maxwell disclosed
22 the reasons for the resignation, even though such a disclosure is not generally required.
23 Defendants dispute this. (Reply at 8 (citing 17 C.F.R. § 229.304(a)(1)(v))).
24 Defendants also argue that if McGladrey LLP believed that the CEO and CFO had
25 engaged in fraud, it would have been required to report this fact to the SEC. (*Id.* at 8-
26 9). Defendants point out that a new auditor relied on management’s representations.
27 Plaintiff argues that this only points to an “economic opportunity” for the new auditor,
28 and is not an implicit blessing of management’s integrity. (Opp’n at 18).

1 Based on the information alleged, this Court cannot find that the resignation
2 alone gives rise to a strong inference of scienter. One auditor was willing to trust the
3 representations, and one was not. This Court has no information that allows it to draw
4 stronger inferences from one more than the other. An independent auditor's
5 resignation because it feels it cannot rely on management's representations may, under
6 certain circumstances, support an inference that the company was misrepresenting or
7 concealing its financial health. *In re Am. Apparel, Inc. Shareholder Litig.*, 855 F.
8 Supp. 2d 1043, 1083 (C.D. Cal. 2012). However, such a recognition by itself does not
9 demonstrate that management acted intentionally or recklessly, rather than acting
10 incompetently, in ignorance, or based on a mistake. *See id.* at 1084. This Court does
11 not know why McGladrey concluded that it could not rely on the statements of
12 management. There is no indication that McGladrey believed either individual
13 defendant was engaged in the misconduct, and no evidence was presented to suggest
14 that McGladrey had any information about what Schramm or Royal knew about the
15 misconduct. Without additional explanation about the reasons for resigning and the
16 basis for their mistrust, the resignation alone does not indicate that the individual
17 defendants had scienter. However, the fact that McGladrey felt it could not trust the
18 representations of management does indicate that the auditors had doubts about the
19 individual defendants' willingness to be truthful or forthcoming with respect to the
20 misconduct. The Court considers the resignation in the holistic analysis.

21 iv. False Certifications, GAAP Violations, and the Need to Restate

22 Plaintiff points to the false SOX certifications and "numerous admitted GAAP
23 violations" as contributing to a strong inference of scienter. (Opp'n at 19). It
24 emphasizes the importance of the inflated earnings, and claims that if they actually had
25 designed and evaluated internal controls over financial reporting as they stated in the
26 certifications, the "substantially inflated financial results and GAAP violations could
27 not have escaped notice." (*Id.* at 19-20).

28 Plaintiff also contends that the admissions made during the restatement provide

1 strong support for inferring scienter. Plaintiff points to the fact that Maxwell restated
2 nearly two years of financial results and admitted that there was deliberate accounting
3 misconduct. Plaintiff cites to *Backe v. Novatel Wireless, Inc.*, 607 F. Supp. 2d 1145,
4 1161-63 (S.D. Cal. 2009), *on reconsideration*, 642 F. Supp. 2d 1169, 1186 (S.D. Cal.
5 2009), in which a district court found scienter based in part upon early product
6 shipment, GAAP violations, and the simplicity of the accounting principles involved.

7 Defendants contend that the circumstances of the restatement do not give rise to
8 a strong inference of scienter. (Mot. at 11). They emphasize that merely restating
9 financial statements or failing to follow GAAP is insufficient, without more, to
10 establish scienter. (*Id.* (citing *DSAM Global Value Fund v. Altris Software, Inc.*, 288
11 F.3d 385, 390 (9th Cir. 2002))). Defendants argue that a financial restatement can
12 suggest that internal controls were ineffective, but that this is not enough to
13 demonstrate that a CEO or CFO acted with scienter.

14 The Court agrees with Defendants that these facts alone do not give rise to a
15 strong inference of scienter. GAAP violations and false certifications can take place
16 where there is no scienter. However, Plaintiff appears to argue in the briefing that,
17 given the nature of the violation, Defendants could not have missed the violations if
18 they evaluated the internal controls as they claimed. Although the large amount at
19 issue suggests Plaintiff's argument may be plausible, this Court does not have the
20 information to evaluate this argument and conclude there is a strong inference of
21 scienter. Plaintiff has not presented the necessary information about accounting
22 principles and internal controls to allow this Court to evaluate whether the individual
23 defendants should have been or must have been aware of the violations.

24 v. Core Operations

25 The Ninth Circuit has stated that as a general matter, corporate management's
26 general awareness of the day-to-day workings of the business does not establish
27 scienter, at least absent additional allegation of specific information conveyed to
28 management and related to the fraud or other allegations supporting scienter. *S. Ferry*

1 *LP, No. 2*, 542 F.3d at 785 (citation omitted). However, allegations regarding
2 management's role in a corporate structure may be considered as part of the holistic
3 analysis required in *Tellabs*, and such allegations can independent satisfy the PSLRA
4 where they are "particular and suggest that defendants had actual access to the disputed
5 information." *Id.* at 785-86. Management's role and the importance of the corporate
6 information may create a strong inference of scienter when made in conjunction with
7 "detailed and specific allegations about management's exposure to factual information
8 within the company." *Id.* at 785; *Zucco*, 552 F.3d at 1000. In "rare circumstances,"
9 particularized allegations are not needed where the nature of the relevant fact is of such
10 prominence that it would be "absurd" to suggest that management did not have
11 knowledge of it. *S. Ferry LP, No. 2*, 542 F.3d at 786.

12 Plaintiff asserts that the inference of scienter is strengthened because the revenue
13 recognition scheme involved Maxwell's "core business." (Opp'n at 20). Plaintiffs also
14 allege that Maxwell operated under an "executive-centric, top-down organizational
15 structure" in which major changes to contract and payment arrangements had to be
16 approved by senior executives, and material changes to payment terms for sales had to
17 be approved by Royal and/or Schramm. (Compl. ¶ 31).

18 Defendants reject the suggestion that scienter is supported by the individual
19 defendant's high-level positions and "top-down" corporate structure, and cite to cases
20 in which high rank is insufficient to infer scienter. The Court agrees that rank alone
21 does not suffice to infer scienter. There is also insufficient information before this
22 Court for the Court to conclude that it is "absurd" to suggest that the individual
23 defendants did not have knowledge of the improper accounting. The inflation of
24 revenue arose out of a combination of side deals, many of which were allegedly carried
25 out by Andrews, and the failure to communicate those deals to the people who should
26 have adjusted the revenue reported. Plaintiff has not demonstrated to this Court that
27 lack of awareness of this fact rises to the level of absurdity.

28 The Court also concludes that Plaintiff has not made the necessary "detailed and

1 specific allegations” about management’s exposure to information to give rise to a
2 strong inference of scienter. Although Plaintiff has alleged that the individual
3 defendants attended sales-related meetings and had access to sales reports, this does not
4 support the inference that the individual defendants must have known about the
5 accounting misconduct. Indeed, it is not clear to this Court exactly what information
6 Schramm and Royal would have had about what revenue was actually counted and
7 whether the meetings and reports should have alerted them to the fact that this
8 information was not accurate.

9 However, the Court does take into consideration in its holistic analysis that the
10 scheme involved core operations of Maxwell’s business and that the individual
11 defendants were allegedly involved or apprised on a regular basis of relevant facts,
12 such as sales and revenue collection. It considers that the organizational structure
13 allegedly required the individual defendants to be involved in certain sales and credit
14 decisions. It also takes into consideration the magnitude of the overstatement, which
15 comprised millions of dollars, and the long duration of the scheme. These facts make
16 it more likely that the individual defendants were or could have been aware of the
17 wrongdoing.

18 vi. Approval and Holds

19 Plaintiff’s Complaint alleges that the individual defendants were involved in or
20 informed of various aspects of sales. It alleges that violations were “well-known” to
21 individual defendants because they inflated revenue by secretly modifying the payment
22 terms, but failing to inform accounting so that it was recognized as revenue. (Compl
23 ¶ 58). Plaintiff alleges that they were able to engage in fraud and cover their tracks by
24 lifting the credit holds on the distributors who did not pay them. (*Id.* ¶ 60)

25 These allegations are insufficient to independently establish a strong inference
26 of scienter. Even if the individual defendants knew about the extension of special
27 terms to certain customers, and authorized lifting credit holds, this does not indicate
28 that they knew there was an accounting problem. Other than conclusory statements,

1 Plaintiff does not plead any particular facts that indicates that the individual defendants
2 knew that the special terms and side deals were unreported. Plaintiff may be
3 suggesting that individual defendants knew about the side deals, should have known
4 that revenue should therefore not be recognized, and would have seen the inconsistency
5 in financial statements. However, Plaintiff has not pleaded facts from which this Court
6 could make those logical leaps. Close monitoring of accounts and sales does not
7 necessarily indicate that the individual defendants would have known that the final
8 reported accounting numbers were manipulated. Plaintiff has not pled sufficient
9 information about the practices of the company to permit this Court to determine
10 whether the individual defendants could have learned information about particular sales
11 and believed the financial statements to be accurate.

12 However, the Court does consider the fact that the individual defendants had
13 access to some sales information, knew about at least some payment problems, and that
14 company policy called for them to approve lifting credit holds.

15 vii. Investigations

16 Defendant argues that as a restatement alone does not give rise to a strong
17 inference of scienter, neither can the “routine consequences” of a restatement. (Mot
18 at 11). Defendants claims that such routine consequences include the signing of
19 certifications, resignations and terminations of officers and employees engaged in
20 intentional misconduct, the company concluding that internal controls are weak, or a
21 government investigation. (*Id.*)

22 With respect to the post-restatement investigation, Defendants contend that
23 government investigations are routine after a financial restatement. (*Id.* at 12-13).
24 Plaintiff argues that this fact nonetheless contributes to a strong inference of scienter,
25 especially in the wake of the recognition of other internal control problems. (Opp’n
26 at 21). Without other information regarding the investigation, this Court cannot find
27 that the investigation gives rise to a strong inference of scienter. Even if the
28 investigation reflects the fact that there was misconduct and that there is suspicion that

1 laws were broken, this does not indicate that Schramm or Royal are suspected of
2 misconduct, much less allow this Court to infer scienter. It is established that there
3 were problems in the financial statements. Plaintiff has not demonstrated how the post-
4 disclosure investigation supports the conclusion that these particular individuals had
5 the required mental state.

6 Plaintiff also alleges that Maxwell recognized internal control problems *before*
7 the Class Period. The DOJ and SEC investigated Maxwell and filed actions against
8 Maxwell for violations of the Foreign Corrupt Practices Act (FCPA) that involved the
9 payment of \$2.5 million in illicit kickbacks to foreign officials to secure and retain
10 contracts. (Compl. ¶ 33). Plaintiff points to SEC charges that Maxwell did not
11 disclose the material revenues and profits from the bribery scheme, that former
12 Maxwell officers knew about and tacitly approved payments, that payments were not
13 accurately recorded, and that Maxwell failed to implement or maintain a system of
14 effective internal accounting controls. (*Id.* ¶ 34). Maxwell entered into a deferred
15 prosecution agreement which admitted responsibility (*Id.* ¶ 35). Plaintiff's Complaint
16 also cites two recent law enforcement investigations. (*Id.* ¶¶ 36, 37). In the briefing,
17 Plaintiff cites to case law that points out that, after the occurrence of a crisis that could
18 repeat itself, there is incentive to review results and assess the possibility of future
19 problems. (Opp'n at 21 (citing *Reese*, 2014 WL 555911, at *8)).

20 Defendants contend that pre-Class Period settlement of "unrelated" FCPA
21 violations in China is irrelevant. (Mot. at 13). They point out that Maxwell disclosed
22 the FCPA violations to the government and claim that Maxwell cooperated with the
23 investigations. They also point out that there were no allegations of wrongdoing
24 against Schramm or Royal.

25 This Court finds that the prior investigation does not give rise to a strong
26 inference of scienter, and does little to increase the plausibility of Plaintiff's
27 allegations. Schramm and Royal do not appear to be directly implicated in the FCPA
28 misconduct. Although the earlier violations do generally suggest problems in at least

1 some aspects of Maxwell's internal controls, there is no evidence before this Court to
2 suggest that these past failings in China dealings made it more likely to have internal
3 control problems with revenue recognition, or that it should have put the individual
4 defendants on alert with regard to internal controls for revenue recognition.

5 C. Defendants' Arguments in Opposition to Scienter

6 In seeking to dismiss this action, Defendants point to allegations and publicly-
7 available evidence that they contend undermines a finding of a strong inference of
8 scienter.

9 i. Stock Holdings and Lack of Sales

10 Defendants argue that allegations of scienter are undermined by the fact that the
11 individual defendants owned a large number of Maxwell shares, and did not sell them.
12 They point out that when the stock price fell as a result of the disclosure, both
13 individual defendants sustained losses. Schramm's stock was worth \$6,273,992 at the
14 Class Period high, and fell to \$1,749,023 after the March 19, 2013 disclosure.
15 Schramm also purchased additional Maxwell stock on the open market between June
16 3, 2011 and August 15, 2012. Royal's stock was worth \$1,601,300 at the high point,
17 and fell to \$446,400 after the March 19 disclosure. Defendants argue that it is
18 "inconceivable" that they would hold their shares if they knew there was a problem.
19 (Mot. at 8). They further point out that these losses are larger than the 2011 bonuses
20 of \$400,000 for Schramm and \$135,800 for Royal. (*Id.* at 7-8).

21 Defendants point to case law in which courts found that a strong inference of
22 scienter is contradicted where individual defendants do not sell their stock or retain a
23 large percentage of stock. (*Id.* at 8; *e.g. In re Wet Seal, Inc. Sec. Litig.*, 518 F. Supp.
24 2d 1148, 1177-78 (C.D. Cal. 2007) (finding that a lack of tangible personal benefit,
25 including lack of insider sales, weighs against scienter)). This Court has examined the
26 cited cases. To the extent they support Defendants' contention, they rely on the
27 common-sense notion that a party will generally not engage in illicit behavior that will
28 cause financial losses to himself or herself.

1 Plaintiff argues that lack of stock sales does not preclude finding a strong
2 inference of scienter. (Opp'n at 22-23). The Ninth Circuit has held that a lack of stock
3 sales by a defendant is not dispositive as to scienter. *No. 84 Employer-Teamster Joint*
4 *Council Pension Trust Fund v. Am. West Holding Corp.*, 320 F.3d 920, 944 (9th Cir.
5 2003) (finding scienter despite lack of stock sales). Plaintiff also argues that there are
6 many reasons why the lack of sales does not necessarily negate scienter. Plaintiff
7 offers a number of plausible reasons why the defendants might not sell stock despite
8 being aware of the misconduct, including a belief that fraud would continue unabated
9 and recognition that sales could be highly incriminating if the fraud were uncovered.
10 (Opp'n at 23).

11 The fact that there were no stock sales during this period can be interpreted to
12 support an inference that Schramm and Royal were unaware of this misconduct.
13 However, it is also consistent with the inference that the individual defendants
14 mistakenly believed that the fraud would remain hidden and they ultimately would be
15 able to reap the benefits of the inflated stock value. The individual defendants may
16 well have believed that they could engage in fraud and retain their stock without
17 suffering financial losses.

18 ii. Individual Defendants' Bonuses

19 Plaintiff points to Maxwell's situation before the Class Period. It alleges that it
20 faced increased competition and lost market share. (Compl. ¶ 38). Maxwell reported
21 "significant net losses" between 2007 and 2009. (*Id.* ¶ 39). Plaintiff contends that this
22 incentivized individual defendants to turn Maxwell's performance around by padding
23 financial results because their compensation was affected by these results. (*Id.* ¶ 39).
24 Plaintiff also questions the compensation program, pointing out that despite losses and
25 financial shortcomings, the individual defendants were able to meet the "ever-changing
26 criteria." (*Id.* ¶ 40).

27 Defendants contend that the bonuses are insufficient to support scienter. They
28 suggest that the program is an unremarkable plan designed to reward performance for

1 certain goals. They also point to the fact that the 2011 bonus was lower than the 2010
2 bonus, and that there was no 2012 bonus. (Mot. at 10).

3 The existence of performance-based compensation provides motive for the
4 individual defendants to order or ignore misconduct that would increase revenues. The
5 Court considers this in its holistic review. However, the fact that the individual
6 defendants would benefit personally from apparent improvement in Maxwell's
7 financial performance does not create a strong inference that the individual defendants
8 had knowledge or were deliberately reckless regarding the misconduct. Plaintiff's
9 allegations that compensation criteria was manipulated to ensure bonus payment, at
10 most, calls into question the integrity of the compensation committee, but does not
11 make it more likely that the individual defendants knew about accounting misconduct.
12 Indeed, if the existence of performance-based compensation and motive to increase
13 short-term profits were enough to establish scienter, scienter could be found for almost
14 any executive. *See Lipton v. Pathogenesis Corp.*, 284 F.3d 1027, 1038 (9th Cir. 2002)
15 (citation omitted) ("If scienter could be pleaded merely by alleging that officers and
16 directors possess motive and opportunity to enhance a company's business prospects,
17 'virtually every company in the United States that experiences a downturn in stock
18 price could be forced to defend securities fraud actions.'").

19 iii. Sales Agreement

20 Plaintiff argues that Maxwell benefitted from the misconduct by entering into
21 an agreement relating to the sale of stock, which ultimately produced \$10.3 million in
22 net proceeds. (Compl. ¶ 48). These sales took place at allegedly inflated prices several
23 weeks before Maxwell reported disappointing financial results on April 26, 2012. (*Id.*
24 ¶ 49). The Ninth Circuit has held that stock sales must be "significant enough and
25 uncharacteristic enough to cast doubt on the defendant company's motives" in order
26 to create a strong inference of scienter. *Zucco*, 552 F.3d at 1006. Although it netted
27 significant proceeds, Plaintiff has not presented evidence to show that such an offering
28 was uncharacteristic or out of the ordinary. This sale does not create a strong inference

1 of scienter.

2 iv. The Audit Committee's Investigation and Results

3 Defendants point to the fact that neither Schramm nor Royal was found by the
4 audit committee's investigation to be aware of the improper arrangements, and that the
5 sales arrangements were never communicated to the finance department. (Mot. at 12).
6 Defendants argue that terminations and resignations of other employees after the
7 investigation, including Andrews, do not prove anything about Schramm or Royal, and
8 show that proper remedial actions were taken. (*Id.*).

9 Plaintiff argues that the strong inference of scienter far outweighs any competing
10 inference provided by self-serving, self-exonerating findings of the audit committee.
11 (Opp'n at 22). Plaintiff points out that it has not had a chance to examine the audit
12 committee's investigation and cites to caselaw that recognizes potential problems with
13 relying upon an audit committee's investigation of its own company. (*Id.*; *In re LDK*
14 *Solar Sec. Litig.*, 584 F. Supp. 2d 1230, 1246 (N.D. Cal. 2008) (“[O]fficers and
15 directors are not exonerated when their own audit committee finds nothing wrong in
16 the company's accounting practices. To rule otherwise would create a huge
17 fox-guards-the-chicken-house loophole in our private securities law enforcement.”)).
18 Defendants reply that the case law cited by Plaintiff indicates that the audit committees
19 finding is not dispositive, not that it is irrelevant, and points out that Plaintiff has not
20 alleged facts questioning the sufficiency of the investigation. (Reply at 7 n.4).

21 The Court takes into account the audit committee's finding, but does not find it
22 decisive. That the audit committee conducted an investigation and did not find that the
23 individual defendants had knowledge supports the individual defendants' claim that
24 they lacked scienter. However, this Court will not dismiss the action based on the
25 findings of a committee which have not been presented or examined. The Court does
26 agree that the firings and resignations of non-defendants after the investigation do not
27 necessarily indicate that the individual defendants knew what those employees were
28 doing or participated in the misconduct.

1 D. Holistic Consideration

2 As discussed above, none of the individual allegations is sufficient to raise a
3 strong inference of scienter. However, the Supreme Court's decision in *Tellabs* permits
4 "a series of less precise allegations to be read together to meet the PSLRA
5 requirement." *S. Ferry*, 542 F.3d at 784. The Ninth Circuit has cautioned that "[e]ven
6 if a set of allegations may create an inference of scienter greater than the sum of its
7 parts, it must still be at least as compelling as an alternative innocent explanation."
8 *Zucco*, 552 F.3d at 1006.

9 Here, the primary innocent explanation is that Schramm and Royal did not know
10 about the improper financial misstatements and the failing in the internal controls, and
11 were not deliberately reckless. After full review of the pleadings and the briefing on
12 scienter, the Court has carefully weighed Plaintiff's allegations, the competing
13 inferences, and innocent explanations. The Court concludes that, considered
14 holistically, the Complaint as currently pled does not raise a strong inference of
15 scienter.

16 Many of Plaintiff's allegations are consistent with the individual defendants'
17 knowledge and participation in improper accounting. However, these facts are also
18 consistent with a scenario in which other employees carried out improper accounting
19 without the knowledge, direction, or deliberate recklessness of the individual
20 defendants.

21 Viewed in the aggregate, Plaintiff alleges that the individual defendants did have
22 some significant pieces of information related to the fraud. The individual defendants
23 had regular access to some sales information, and the accounts of confidential
24 witnesses indicate that Schramm and Royal were or should have been aware of some
25 revenue collection problems. One confidential witness reports learning that some
26 information about possible inconsistencies was given to Schramm. The confidential
27 witness accounts of the structure of the company indicates that one or both of the
28 individual defendants were supposed to be involved in some decisions involving

special sales terms or lifting credit holds. The individual defendants also clearly had information about the revenue numbers, and signed the certifications for the financial statements containing the reported revenue numbers. The restatement indicates that the revenue numbers were substantially overstated for a period of nearly two years. The individual defendants had a financial motive to improve the appearance of the Maxwell's financial performance, if they believed the fraud would not be discovered.

However, this is not sufficient to allow this Court to infer scienter. There are no specific facts alleging that an individual defendant acknowledged that revenue was misreported or ordered anyone to misreport anything. There are no specific allegations about the information accessed by the individual defendants or the nature of the accounting process which, taken in combination, suggest that the individual defendants must have known that there was an accounting deception or were deliberately reckless. This Court also considers the fact that both individual defendants suffered financial losses and that none of the internal or external investigators have yet placed blame on the individual defendants. Although the allegations suggest that it is possible that the individual defendants had the requisite scienter, without additional allegations, Plaintiff's theory is not as cogent and compelling as the innocent explanation.

CONCLUSION

As Plaintiff has failed to sufficiently allege scienter, the Motion to Dismiss is **GRANTED**. This Court need not address the loss causation arguments briefly raised by the parties. However, as Plaintiff's arguments suggest that it may be able to clarify its Complaint and add additional well-pleaded allegations regarding scienter, this Court

///

///

///

///

///

///

1 grants leave to amend. If Plaintiff wishes to file an amended consolidated complaint,
2 it must do so **no later than** 30 days after the date this Order is filed.

3 **IT IS SO ORDERED.**

4
5 DATED: May 5, 2014

6
7 
8 Hon. Roger T. Benitez
9 United States District Judge
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28